

Internal Revenue Service
memorandum

CC:TL:Br2
JM Orenstein

date: AUG 5 1986

to: District Counsel, Dallas CC:DAL

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

We were requested by you to respond to the memorandum of May 28, 1986, from the Dallas Appeals Office to you. Your request for technical advice pertains to the above-named taxpayer. You requested our advice concerning the issues set out below which are addressed in a National Office Technical Advice Memorandum and a Revenue Ruling which is about to be issued based on that technical advice memorandum.

ISSUES

1. Whether the provisions of section 47 of the Code require the recapture of previously claimed investment credit upon the transfer of section 38 property from a corporation to two newly formed corporations, in a divisive reorganization under section 368(a)(1)(D). 0047.01-00

2. If recapture is required pursuant to section 47, whether the recapture should take place in the taxable year in which the section 38 property was transferred to the newly formed corporations, or in the following year when the stock of the newly formed corporations was transferred to the shareholders of the predecessor corporation. 0047.01-00.

CONCLUSION

1. The provisions of section 47 require the recapture of previously claimed investment credit upon the transfer of section 38 property from a corporation to two newly formed corporations, in a divisive reorganization under section 368(a)(1)(D).

2. Recapture is required to take place in the year in which the section 38 property was transferred to the newly formed corporations, where the stock of the newly formed corporations was transferred to the shareholders of the predecessor corporation pursuant to a pre-arranged plan.

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FACTS

On [REDACTED], [REDACTED] sent out a news release which announced a plan of reorganization. [REDACTED] proposed to transfer the assets of its [REDACTED] and [REDACTED] products divisions to two newly formed corporations in exchange for the stock of those corporations. The plan further provided that [REDACTED] would transfer the stock received in the transaction to the [REDACTED] shareholders in the form of a tax-free dividend.

Following the incorporation of [REDACTED] and [REDACTED], the actual transfer of assets and liabilities took place on [REDACTED] the last day of [REDACTED]'s fiscal year. The assets transferred included section 38 property for which [REDACTED] had previously claimed investment credit. On [REDACTED], the stock of [REDACTED] and [REDACTED] was transferred to the shareholders of [REDACTED].

Pursuant to a request from [REDACTED] the Service had issued a ruling that the transfer of assets and liabilities to [REDACTED] and [REDACTED] in exchange for stock followed by the distribution of the stock to [REDACTED]'s shareholders would qualify as a reorganization pursuant to section 368(a)(1)(D). This ruling did not in any way address the recapture of investment credit.

Neither [REDACTED]'s federal income tax return for the year ending [REDACTED] nor the return for the year ending [REDACTED] took into account any recapture pursuant to section 47. The District Director proposed that [REDACTED] recapture the previously claimed investment credit in the year the assets were transferred. The year the stock was transferred to the shareholders, [REDACTED], is closed by the statute of limitations.

DISCUSSION

Issue 1. Whether the investment credit taken by [REDACTED] must be recaptured

Section 38 provides a credit against income tax liability for a taxpayer's investment in certain depreciable property used in its trade or business.

Section 47(a)(1) provides the rule for early dispositions of section 38 property as follows:

If during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

There are a number of exceptions to section 47(a)(1)'s recapture rules. The most notable exception and the only exception potentially applicable in this case is the "mere change in form" exception which is provided in section 47(b). Under this exception, section 38 property will continue to be section 38 property "so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business." I.R.C. § 47(b).

Section 1.47-3(f)(1)(i) of the regulations defines the conditions which must be met in order to qualify for the mere change in form exception. These conditions are:

- (a) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property in the same trade or business,
- (b) The transferor (or in a case where the transferor is a partnership, estate, trust or electing small business corporation, the partner, beneficiary or shareholder) of such section 38 property retains a substantial interest in such trade or business,
- (c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and

(d) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor.

The only condition which is troublesome in this particular case is the substantial interest test. If [REDACTED] maintained a substantial interest in the assets of [REDACTED] and [REDACTED], then section 47(b) applies and there will be no recapture of investment credit. The legislative history to section 47 makes it clear that the determination as to whether a substantial interest has been maintained in the corporation should be made each time the taxpayer relinquishes his interest. Thus, in Example 2 of S. Rep. No. 1881, 87th Cong. 2d Sess. 153 (1962), 1962-3 C.B. 857, the issue is illustrated:

On January 1, 1963, the X corporation acquires and places in service a new section 38 property (with an estimated useful life of 6 years) which it takes into account in computing a credit. Such property is used in X's manufacturing business. X corporation is also engaged in a separate personal service business. In 1964, the X corporation transfers the assets of the manufacturing business (including the sec. 38 property upon which the X corporation took a credit) to a newly formed corporation, the Y corporation. X corporation then transfers to its shareholders all of the stock of the Y corporation. Since the X corporation does not retain a substantial interest in the manufacturing business, section 47(a) will apply to the transfer of the assets to Y corporation.

Additionally, the Service has previously ruled that such a transaction requires recapture of the investment credit. In Rev. Rul. 74-101, 1974-1 C.B. 7, X formed two new corporations, Y and Z. X transferred section 38 property in exchange for the stock of Y and Z. Upon receipt of the stock, X distributed the shares to its sole shareholder. After commenting that this transaction constituted a divisive reorganization within the meaning of section 368(a)(1)(D), the ruling went on to hold that such a transaction required recapture of investment credit pursuant to section 47(a)(1) since the taxpayer, X corporation, did not retain a substantial interest in the business.

With the exception of the timing issue, the facts regarding the nature of the [REDACTED] transaction are substantially identical to both Example 2 of the legislative history and Rev. Rul. 74-101. As a result, it is clear that [REDACTED] must recapture the investment credit it previously took with respect to the section 38 property transferred to [REDACTED] and [REDACTED].

Issue 2: In what year must the investment credit be recaptured

While both the example cited in the legislative history and Rev. Rul. 74-101 address the recapture issue sufficiently, they do not deal with the situation where the events leading to recapture take place in two taxable years. Thus, it must be determined whether the recapture applies to the transfer of assets or the distribution of stock to [REDACTED]'s shareholders.

As cited earlier, Example 2 presents a similar factual situation. The example concluded by holding that the recapture provisions of section 47(a) would apply to the "transfer of the assets."

The facts presented in [REDACTED] are a good illustration of why recapture applies to the asset transfer rather than the stock transfer. The subsequent distribution of the [REDACTED] stock was part of a pre-arranged plan to transfer ownership of [REDACTED] and [REDACTED] to the [REDACTED] shareholders. The [REDACTED] news release made clear that this transaction was one complete package. By making the distribution of stock in a second taxable year, [REDACTED] hoped to postpone the recognition of income.

Consequences of a transaction are determined on the basis of the substance of the transaction and not its form. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). A mere transfer in form, without substance, may be disregarded for tax purposes. Commissioner v. P.G. Lake, Inc., 356 U.S. 260 1958; Commissioner v. Court Holding Co., supra; Commissioner v. Sunnen, 333 U.S. 591 (1948); Helvering v. Clifford, 309 U.S. 331 (1940); Corliss v. Brown, 281 U.S. 376 (1930). An equally well established corollary to this principle is the step-transaction doctrine under which independent tax recognition is not given to a series of integrated transactions. The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of a transaction. Redding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981). A transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation is relevant. To permit the true nature of a transaction to be distinguished by formalisms which exist solely to alter tax consequences would seriously impair the effective administration of the tax policies. Commissioner v. Court Holding Co., supra at 334.

Essentially, there have evolved three tests for applying the step-transaction doctrine: the "end result" test, where it is determined that a series of steps are component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result; the "interdependence test", wherein it is determined that the steps taken would have been fruitless without completion of the series; and the "binding commitment" test, in which a determination must be made that once the first step occurs, the parties to the transaction are bound to take the later steps. See generally, McDonald's Restaurants, Inc. v. Commissioner, 688 F.2d 520, 524-525 (7th Cir. 1982); B. Bitker and J. Eustice, Federal Income Taxation of Corporations and Shareholders, 14.51 (4th ed. 1979).

In the present case, the step-transaction doctrine may be applied by using two of the aforementioned tests. It is clear from the press release that [REDACTED] intended, from the beginning, to transfer the stock of [REDACTED] and [REDACTED] to the [REDACTED] shareholders. While this transfer may not have been necessary to accomplish any specific purpose, it was clearly the ultimate result that [REDACTED] had been seeking from the outset. For this reason, the "end result" test may apply to the transactions in this case.

An argument can also be made that [REDACTED] had made a "binding commitment" to its shareholders. This would be the case if [REDACTED] were equitably estopped to refuse to issue the [REDACTED] and [REDACTED] shares as a dividend. This estoppel theory was applied to the step-transaction doctrine in Blake v. Commissioner, 697 F.2d 473 (2d Cir. 1982). Blake involved a charitable contribution by a taxpayer of substantially appreciated stock followed by a liquidation of the contribution and purchase of another asset from the donor. The Service argued and the Court held that the transaction should be recharacterized as a sale of the stock by the taxpayer followed by a contribution of the asset to the charity. The transactions were stepped together on a promissory estoppel theory when the court determined that "a mere gratuitous promise by the Fund that it would purchase the America became legally binding when Blake acted in reliance on such an assurance." Blake at 477.

Similarly, the estoppel theory could be applied here by showing that old shareholders relied on the press release in refraining from selling their stock or that new shareholders were induced to purchase [REDACTED] stock by relying on the press release. Thus, if [REDACTED] had failed to make the distribution, such action might have been compelled through shareholder action. As a result, as in Blake, a binding commitment could be said to have existed.

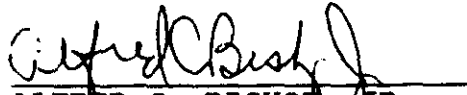
No matter which test is applied, it is clear that the transactions should be stepped together. In that regard, the transaction would be deemed to have occurred upon the transfer of the assets to [REDACTED] and [REDACTED] in [REDACTED] of [REDACTED] and the investment credit must be recaptured during that taxable year.

CONCLUSION

In order to be exempt from recapture of its previously taken investment credits, [REDACTED] was required to maintain a substantial interest in the assets transferred. When it subsequently divested itself of the [REDACTED] and [REDACTED] stock it failed to maintain that substantial interest. Moreover, this stock distribution was part of a pre-arranged plan. Thus, [REDACTED] must recapture investment credits during the taxable year ending [REDACTED], the year in which the assets were transferred.

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By:


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